ARNOLD & PORTER UPDATE

The SEC Issues New Standards of Professional Conduct for Attorneys

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There is some good news for issuers and their counsel. In response to significant concerns raised by lawyers, bar associations and others, the Securities and Exchange Commission (the "Commission") has substantially modified its proposed rule setting professional standards for attorneys appearing and practicing before the Commission. The final rule, issued on January 29, 2003, will take effect on August 5, 2003, a delay intended "to provide issuers, attorneys, and law firms sufficient time to put in place procedures to comply with their requirements." SEC Release 2003-13. The delay in implementation will also permit the Commission to extend rulemaking on a "noisy withdrawal" provision.

The Sarbanes-Oxley Act – Minimum Standards for Attorneys

Section 307 of the Sarbanes-Oxley Act of 2002 ("the Act"), passed in the wake of corporate financial scandals that many believe would not have been possible without the knowledge – if not the assistance – of the issuers' counsel, requires the Commission to establish rules "in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers . . . ." Specifically, the Commission must issue a rule requiring attorneys who appear and practice before the Commission to "report evidence of a material violation of the securities law or breach of fiduciary duty or similar violation by a company or any agent thereof" first, to the Chief Legal Officer ("CLO") or CEO or their equivalent and, if that officer does not "appropriately respond to the evidence," to the audit committee of the board of directors or another committee of independent directors or to the full board itself.

The Rulemaking Proceeding

The Commission released proposed rules, 17 CFR § 205, implementing Section 307 on November 21, 2002. Those proposed rules went far beyond the mandates of the Act. In attempting to ensure that no material wrongdoing would go undetected and, once detected, that the issuer would

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appropriately respond, the proposed rule brought under its aegis any attorney who provided advice or assisted in drafting documents that were subsequently submitted to the SEC, whether or not that attorney knew that her advice or document would be so incorporated. The proposed rule so broadly defined the type of wrongdoing and the quantum of awareness an attorney needed in order to trigger the up-the-ladder reporting requirement, that there was concern that the rule would result in significant over-reporting of suspected wrongdoing by counsel who were not qualified to evaluate their suspicions and who were concerned that failure to report might subject them to disciplinary proceedings or personal liability for violating the Act. The ability of counsel to conduct an internal investigation and comply with the up-the-ladder reporting requirements seemed compromised by the requirement that counsel "document" their compliance and retain such documentation for "a reasonable time." Finally, under certain circumstances, the proposed rule required counsel to engage in a "noisy withdrawal," publicly disavowing any document or representation in a submission or filing made with the Commission that counsel reasonably believed to contain a material misrepresentation.

Extended Rulemaking for "Noisy Withdrawal" Provisions

The Commission has extended the comment period on the original "noisy withdrawal" provision and a modified rule, released on January 29, 2003. The new proposed Rule 205.3(d)-(f), 17 CFR § 205.3(d)-(f), would require an attorney to withdraw, provide written notice to the issuer that his withdrawal is based upon "professional considerations," and require the issuer – not counsel – to report counsel's withdrawal and "the circumstances related thereto" as a material event on Form 8-K, 20-F or 40-F. Although the attorney would not be required to withdraw from the representation if prohibited from doing so by a court or other authority with jurisdiction over the attorney, the attorney would still be required to provide written notice to the issuer that, but for such a prohibition, he or she would have withdrawn. If the issuer fails to file the required form with the Commission, the withdrawing attorney may – but is not required to – inform the Commission that he or she has withdrawn based upon "professional considerations." Under the proposed rule, the CLO must notify any attorney hired to replace a withdrawing attorney that the previous attorney had so withdrawn.

The Final Rule: Who is Covered

The rule applies to attorneys who represent publicly traded companies under the Securities Exchange Act of 1934 and/or Securities Act of 1933 ("issuers"), and attorneys employed or retained by a non-public subsidiary of an issuer where that attorney's legal services benefit the issuer. Thus, for instance, an attorney acting on behalf of a non-public subsidiary will be covered, regardless of which entity employs him, when that attorney can invoke claims of privilege on behalf of the issuer.

The rule applies only to those attorneys "appearing and practicing" before the Commission. The final rule has tightened the definition of "appearing and practicing," limiting it to attorneys who: (1) transact business with the Commission, (2) represent an issuer in any proceeding before the Commission, (3) provide advice on compliance with U.S. securities laws "regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission," and (4) advise an issuer with respect to what should be included in any statement required under U.S. securities laws or

Commission rules and regulations. The rule expressly excludes attorneys who are not functioning in a legal capacity or attorneys who qualify as "non-appearing foreign attorneys." Generally speaking, foreign attorneys are covered to the extent they advise clients on compliance with U.S. securities laws, unless they do so in consultation with counsel admitted to practice in the United States. The CLO of an issuer and lawyers who supervise and direct subordinate attorneys who "appear and practice before the Commission," are subject to the rule, as if they personally appeared and practiced before the Commission. Subordinate attorneys who appear and practice before the Commission are not released from any obligations under the rule because they are supervised by another; however, subordinate attorneys can fulfill their up-the-ladder reporting obligations by reporting evidence of a material violation to their supervising attorney.

The Final Rule: The Up-the-Ladder Reporting Process

The final rule sets out in detail the internal up-the-ladder reporting requirements for counsel subject to the rule. Section 205.3(b) governs internal reporting requirements in the absence of a qualified legal compliance committee ("QLCC") and 205.3(c) governs when a QLCC has been duly constituted.

In its final rule, the Commission adopted an "objective" standard for when up-the-ladder reporting requirements are triggered. An attorney who has "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur," must initiate up-the-ladder reporting.

Under 205.3(b), an attorney who learns of evidence of a material violation must report that evidence to the CLO, CEO or their equivalent. The CLO, in turn, must institute an inquiry and respond to the reporting attorney with the basis for determining either that there is or has been no material violation, or, if a material violation is confirmed, take steps to cause the issuer to adopt an appropriate response and so confirm to the reporting attorney. An attorney who believes it would be "futile" to report to the CLO, CEO, or their equivalent, or who does not receive an appropriate response "within a reasonable time" of making a report, is required to report the evidence of a material violation directly to the audit committee, another committee of the board comprised solely of independent directors or the full board of directors.

Where the issuer has already formed a QLCC, the CLO or any other attorney may report evidence of a material violation directly to the QLCC. Once such a report has been made, the reporting attorney's obligations end. The rule sets out specific requirements for the organization and governance of a QLCC. It must be comprised exclusively of independent directors, it must have written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation, and have the power and authority to determine whether an investigation is needed, oversee such an investigation, and retain any "expert personnel" deemed necessary in support of such investigation. At the end of an investigation, the QLCC, acting by majority vote, must be authorized to recommend an "appropriate response" to the issuer, and take any other action deemed appropriate. Finally, the QLCC must be authorized, but is not required, to notify the Commission in the event the issuer fails "in any material respect" to implement an appropriate response that the QLCC has recommended the issuer take.

The Final Rule: What response to evidence of a material violation is appropriate?

A response to a report of evidence of a material violation is appropriate if, as a result, an attorney "reasonably believes" either (1) that there is or has been no material violation or (2) that the issuer has adopted appropriate measures to remedy and address the violation. Although one "appropriate response" may be that the issuer can "assert a colorable defense" in any investigation or judicial or administrative proceeding relating to that evidence, such advice is not an "appropriate response" unless provided by counsel retained or delegated to investigate with specific authorization from the board, a committee of independent directors, or a QLCC. In the event that the CLO retains or directs counsel to assert a defense on behalf of the issuer in an adversary proceeding, the CLO must "provide[] reasonable and timely reports on the progress and outcome of such proceeding" to the board, a committee of independent directors, or the QLCC.

Although the proposed rule requiring an attorney to document any report of or response to evidence of a material violation was withdrawn, the final rule permits an attorney to use any documentation prepared in the process of complying with the rule in any "investigation, proceeding, or litigation in which the attorney's compliance . . . is in issue." It also invites counsel to disclose to the Commission information "to the extent the attorney reasonably believes necessary" to prevent an issuer from committing a material violation that is "likely to cause substantial injury to the financial interest or property of the issuer or investors," to prevent the issuer from committing or suborning perjury likely to perpetrate a fraud on the Commission, or to "rectify" substantial injury to the financial interest or property of the issuer or investors arising from a material violation – past, present or future – "in the furtherance of which the attorney's services were used."

The Final Rule: Effect of a Violation

An attorney who violates the rule will be subject to those civil penalties and remedies available to the Commission under the securities laws. The Commission also can bring disciplinary proceedings to censure or temporarily or permanently bar an attorney from practicing before the Commission. The rule, however, expressly exempts foreign attorneys from compliance "to the extent that such compliance is prohibited by applicable foreign law." Although the ability of Commission rules to preempt state and other law has come under question, the rule purports to preempt state law or ethics rules, expressly providing that any attorney who complies with the rule in "good faith" will not be subject to disciplinary proceedings or held liable under conflicting standards imposed by any state or other jurisdiction. The final rule further protects counsel by providing that there is no private right of action against an attorney for compliance or lack of compliance with the rule, and giving the Commission exclusive authority to enforce compliance with the rule.

Open Issues

The proposed rule generated strong opposition from the bar because it treated attorneys as gatekeepers with fiduciary duties running not simply to the client organization but also directly to investors. The original "noisy withdrawal" provision epitomizes this approach, requiring counsel to violate their obligations of confidentiality to the organization when, in the attorney's judgment, investors could suffer severe financial harm resulting from ongoing or future material violations. As adopted, the final rule reflects a definite retreat from the lawyer-as-gatekeeper model. Commentary prefacing the final rule expressly states that "[t]he Commission does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist." This is good news. Counsel owes a duty of loyalty to the organization. But the organization must operate through its duly authorized governing bodies, and they – not lawyers – must establish the organization's business objectives, policies, and procedures and ensure compliance with the law.

Although the Commission has, at least temporarily, refrained from imposing new, and potentially conflict-laden, obligations on counsel, the Commission has extended the comment period on the original "noisy withdrawal" provision. It has also proposed an alternative withdrawal provision that the Commission believes does not intrude on the traditional relationship between counsel and their corporate clients. Final evaluation of the impact the new rules will have on public companies and their counsel must await the outcome of this extended rulemaking process.

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This memorandum is only a general summary of certain provisions of the Sarbanes-Oxley Act and related SEC rules and should not be construed as providing legal advice. If you have any questions about the Act, please feel free to call Leslie Wharton (202-942-5105) or your Arnold & Porter attorney.